

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Committee on Budget Analyst: Norman Catelli Bill Number: AB 433
Related Bills: See Legislative History Telephone: 845-5117 Amended Date: June 29, 2002
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Suspend Teacher Retention Credit and NOL Deduction/Bad Debt
Conformity/Collections/Delinquent Accounts/VLF

SUMMARY

Provisions of this bill would:

1. Suspend the Teacher Retention Credit for one year (Page 2),
2. Suspend net operating losses (NOLs) for two years, then make the NOL deduction 80% (Page 3),
3. Provide penalty relief for underpayments caused by the tax changes enacted during the 2002 calendar year (Page 7),
4. Assist the Franchise Tax Board (FTB) in pursuing high-risk collection accounts to improve compliance and accelerate the collection of accounts (Page 8),
5. Conform to federal bad debt deduction rules for banks and modify related AMT items (Page 12), and
6. Suspend the Vehicle License Fee (VLF) offset for one year (Page 15).

The provisions of this bill will be discussed separately.

This analysis addresses only those provisions of the bill affecting the FTB.

This is the department's first analysis of this bill.

Revenue Estimate:

Based on the data and assumptions below, revenue effects are as follows:

| Estimated Revenue Impact | | | |
|---|-----------|-----------|-----------|
| Years Beginning On or After January 1, 2002 | | | |
| Fiscal Years | | | |
| (In Millions) | | | |
| | 2002-03 | 2003-04 | 2004-05 |
| Teachers Credit | +\$170 | - | - |
| NOL Deductions | +\$1,200 | +\$800 | -\$375 |
| Estimate Penalty | No Impact | No Impact | No Impact |
| FTB Collections | +\$125 | - | - |
| Bad Debt Reserve | +\$285 | +\$15 | - |
| VLF | - | -\$85 | - |

Board Position:

____ S ____ NA ____ NP
____ SA ____ O ____ NAR
____ N ____ OUA ____ X PENDING

Department Director

Date

Gerald H. Goldberg

7/25/02

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

The revenue discussion is included with each provision.

1. SUSPEND THE TEACHER RETENTION CREDIT

PURPOSE OF THE PROVISION

It appears that the intent of this provision is to suspend the Teacher retention Credit for one year.

EFFECTIVE/OPERATIVE DATE

This bill is an urgency statute; thus, it would be effective immediately, and apply to taxable years beginning on or after January 1, 2002, and before January 1, 2003.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing **federal and state laws** provide various tax credits designed to provide tax relief for taxpayers that incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they might not otherwise undertake.

Current **state law** allows a tax credit for credentialed teachers based upon the taxpayer's years of service as a credentialed teacher. The credit amount varies as follows:

| <u>Years of Service</u> | <u>Credit</u> |
|------------------------------------|---------------|
| At least 4 but less than 6 years | \$250 |
| At least 6 but less than 11 years | \$500 |
| At least 11 but less than 20 years | \$1,000 |
| 20 or more years | \$1,500 |

The credit cannot exceed 50% of the amount of tax that would be imposed on a teacher's salary, excluding pensions or other deferred compensation, after application of the standard deduction or itemized deductions.

THIS PROVISION

This provision would suspend the Teacher Retention Credit for taxable year 2002. There are no carryover provisions for this credit.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

AB 428 (Budget Committee, 2001-2002), contains similar provisions as this bill. The bill is on the Senate floor awaiting a third reading.

AB 2879 (Jackson, Stats. 2000, Ch. 75) enacted the Teacher Retention Credit.

OTHER STATES' INFORMATION

Illinois, Massachusetts, Michigan, Minnesota, and New York laws do not provide a credit comparable to the credit allowed by this provision. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Suspension of the Teachers Retention Credit would generate additional state revenue of \$170 million for the fiscal year 2002-03.

Revenue Discussion

This revenue estimate is based on actual credits claimed in 2000 and 2001, using a 7% growth rate for future years as in the original revenue estimate for the Teacher Retention Credit. The Teacher Retention Credit cannot be carried forward, therefore, the total impact of the suspension is reflected in the 2002-03 fiscal year.

2. SUSPEND NOLs

PURPOSE OF THE PROVISION

It appears that the intent of this provision is to suspend NOLs for two taxable years.

EFFECTIVE/OPERATIVE DATE

This bill is an urgency statute; thus, it would be effective immediately, and by its terms would apply to taxable years beginning on or after January 1, 2002, and before January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Simply stated, NOLs are beneficial tax rules for losses that allow a taxpayer to deduct (offset) those losses in other years when the taxpayer recognizes income.

Federal law provides, in general, that an NOL can be carried back two years and forward 20 years. Special rules are provided for the carryback of NOLs arising from specified liability losses, excess interest losses, casualty or theft losses, disaster losses of a small business, and farming losses. An NOL is defined as the excess of allowable deductions (as specifically modified) over gross income computed under the law in effect for the loss year.

Existing **state law** conforms to the federal computation of an NOL, except for the following modifications: California does not allow NOL carrybacks. In addition, depending on the type of taxpayer or amount of a taxpayer's income, the percentage of the NOL that is eligible to be carried forward and the number of years it can be carried forward varies.

Existing **state law** provides for seven different types of NOLs:

| Type of NOL | NOL % Allowed to be Carried Over | Carryover Period |
|---|---|---------------------|
| General NOL | 55% (2000 - 2001) 60% (2002 - 2003) 65% (2004 - on) | 10 Years |
| New Business Year 1 Year 2 Year 3 | 100% 100% 100% | 10 Years |
| Eligible Small Business | 100% | 10 Years |
| Specified Disaster Loss | 100% 50% | 5 Years 10 Years |
| Economic Development Areas | 100% | 15 Years |

Special NOL treatment as stated in the above chart is provided for the following taxpayers:

New businesses that are engaged in a trade or business activity that first commenced in California on or after January 1, 1994. "New business" special NOL treatment also applies to taxpayers engaged in certain biopharmaceutical activities for taxable years beginning on or after January 1, 1997, that have not received approval for any product from the U.S. Food and Drug Administration.

For taxable years beginning on or after January 1, 1994, eligible small businesses that are engaged in a trade or business activity with gross receipts, less returns and allowances, of less than \$1 million during the taxable year.

Taxpayers that suffer a casualty loss in an area declared a disaster area by the President or Governor may carry over 100% of an NOL for five years and 50% of any NOL remaining after the first five years for an additional 10 years.

Taxpayers that operate a business in an Economic Development Area, including a Local Agency Military Base Recovery Area, a Targeted Tax Area, or an Enterprise Zone. However, NOLs generated in these incentive areas may offset only income generated in the incentive areas, and the taxpayer may claim an NOL from only one incentive area in any year.

In the case of corporations doing business both within and outside of this state, most states, including California, tax corporations on a source income basis. Source income is determined using an apportionment formula for business income and an allocation methodology for nonbusiness income.

While a state cannot tax income from sources outside the state, it is similarly not obligated to consider losses from sources outside the state. Thus, the applicable apportionment rule governing NOLs provides that a taxpayer has a California NOL based on the sum (or net) of California-apportioned business income (or loss) and in allocated nonbusiness income (or loss).

THIS PROVISION

This bill would:

- Suspend all NOLs for the 2002 and 2003 taxable years,
- Extend the carryover period for the suspended years:
 - extend carryover periods for losses incurred before January 1, 2002, by two years,
 - extend carryover periods for losses incurred on or after January 1, 2002, and before January 1, 2003 by one year, and
- Provide that for tax years beginning on or after January 1, 2004, the NOL deduction would be 80% of the loss.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision of the bill would not significantly impact the department's programs and operations.

OTHER STATES' INFORMATION

The laws of *Florida, Illinois, Massachusetts, Michigan, and Minnesota* were reviewed because their tax laws are similar to California's income tax laws.

Florida income tax law, with respect to corporations, provides a 20-year carryover period but no carryback, and otherwise conforms to federal NOL laws. *Florida* has no personal income tax.

Illinois income tax law conforms to federal law regarding NOLs.

Massachusetts income tax law does not allow NOL treatment for personal income taxpayers, but corporations are allowed a 100% NOL that applies to the first five years of the entity's existence.

Michigan income tax law conforms to federal NOL laws, including the allowance of NOL carrybacks for corporations. However, *Michigan's* personal income tax law does not allow NOL carrybacks.

Minnesota personal income tax law conforms to federal NOL laws, while corporate taxpayers have no NOL carrybacks and only a 15-year carryforward period.

LEGISLATIVE HISTORY

SB 169 (Alquist, Stats. 1991, Ch. 117) and AB 31 (Klehs, Stats. 1991, Ch. 474) suspended NOLs for taxable periods beginning in 1991 and 1992. The carryover period for losses incurred in 1991 was extended by one year. The carryover period for losses incurred prior to 1991 was extended by two years.

AB 428 (Budget Committee, 2001-2002), contains similar provisions as this bill. This bill is on the Senate floor awaiting a third reading.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Suspension of the NOL deduction would generate additional state revenue of \$1,200 million for fiscal year 2002-03, and \$800 million for fiscal year 2003-04; followed by a decrease in state revenue of \$375 million during fiscal year 2004-05.

Revenue Discussion

This revenue estimate is based on current departmental information on the utilization of NOLs, adjusted for projected NOL usage in affected years and other pertinent factors.

3. PENALTY RELIEF FOR UNDERPAYMENTS

PURPOSE OF THE PROVISION

It appears that the intent of this provision is to provide relief from underpayment penalties for 2002 to taxpayers that made their estimated payments based on prior tax law.

EFFECTIVE/OPERATIVE DATE

This bill is an urgency statute; thus, it would be effective immediately, and apply to taxable years beginning on or after January 1, 2002.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Generally, **federal and state laws** require taxpayers to make estimated tax payments. Payments are generally made quarterly on a “pay as you go” basis. The payments of calendar year taxpayers are generally due on April 15, June 15, September 15, and December 15. Payments that do not meet prescribed rules, and are not covered by the many exceptions, are subject to an underpayment penalty. For federal purposes, an individual taxpayer does not have an underpayment of estimated taxes if the required estimated tax for the year is less than \$1,000, known as the *de minimis* safe harbor, and,

- The individual makes timely estimated payments equal to 90% of the tax shown on the return, or
- 100% of the tax shown on the return of the individual for the preceding year. A special rule affecting high-income taxpayers with adjusted gross income (AGI) over \$150,000 (\$75,000 if married filing a separate return) applies. Effective for 2002, federal law requires high-income taxpayers with AGI in excess of \$150,000 to make payments of 112% of the individual's tax for the preceding year. For 2003 and years thereafter, the percentage is 110%.

California law generally conforms to these rules with the exception that California maintains a \$200 *de minimis* safe harbor.

Federal and state laws generally require a corporate taxpayer to make timely estimate payments equaling 100% on the tax shown on the return for the current year.

THIS PROVISION

This provision would exempt from the underpayment penalty, for any period before April 15, 2003, any additional tax resulting from the tax changes enacted in the 2002 calendar year.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

SB 657 (Scott, Stats. 2002, Ch. 34), and AB 1122 (Corbett, Stats. 2002, Ch. 35) conformed to federal estimated payment requirements for individuals. Those requirements are noted in the analysis of applicable federal and state law.

OTHER STATES' INFORMATION

Illinois, Massachusetts, Michigan, Minnesota, and New York all provide some procedure to provide relief from penalties for reasonable cause.

The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

This proposal would not impact the state's income tax revenue.

4. PURSUE HIGH-RISK COLLECTIONS

PURPOSE OF THE PROVISION

This provision would allow FTB to identify and offer eligible taxpayers the opportunity to satisfy an unpaid tax liability by paying the tax in full and receiving a waiver of interest, penalties, and fees.

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would become effective upon enactment and states that this provision would be operative October 1, 2002, through June 30, 2003.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing **federal and state laws** impose tax on the income earned by individuals, estates, trusts, and certain business entities. In addition, penalties and fees can be imposed on those taxpayers that fail to file their tax returns or pay their taxes in full.

For state purposes, tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California. The tax for individuals is computed on a graduated scale at rates ranging from 1% to 9.3%. If the taxpayer fails to report or pay their state taxes in full, FTB notifies the taxpayer that collection action may commence, which may include wage garnishments, liens, or other forms of levies.

Existing **state law** imposes interest on any payment of tax that is not paid on or before the last date prescribed for payment and establishes the applicable rate of interest.

The following are the more commonly imposed penalties under current state income tax laws against taxpayers that do not report or underreport their income, or do not pay deficiency assessments:

- Late filing – income tax returns that are filed late are subject to two types of late filing penalties: (1) a basic penalty of 5% of the tax per month that the return is late, up to a maximum of 25% of the tax, or (2) a minimum penalty of the lesser of \$100 or 100% of the tax liability, if the return is filed 60 days or more late and the basic penalty is less than \$100. If the failure to file is due to fraud, the basic penalty is 1% per month, up to a maximum of 75%.
- Underpayment – income taxes that are not paid by the original due date of the income tax return are subject to a penalty of 5% of the unpaid tax PLUS 1/2 of 1% per month, up to a maximum of 40 months (20%).
- Demand – income tax returns that are not filed upon notice and demand from the FTB are subject to a penalty of 25% of the amount of the tax required to be shown on the return.
- Frivolous return – income tax returns that are not sufficiently completed to substantially determine the correct self-assessed tax are subject to a penalty of \$500.
- Accuracy-related – substantial understating income tax, overstating values of items, or overstating pension liabilities are subject to a penalty of 20% of the additional tax that is accuracy related. If the misstatements are due to fraud, the penalty is 75% of that resulting tax.

In addition, taxpayers that fail to file returns or pay their income tax liabilities may be liable for the following fees relating to the enforcement of the income tax return or liability:

- Filing enforcement cost recovery fee -- for individuals that fail to file income tax returns within 25 days after FTB mails its formal legal demand for the returns.
- Collection cost recovery fee -- for individuals that fail to pay their income taxes after FTB mails a notice for payment that advises that continued nonpayment may result in collection action.

THIS PROVISION

For the period of October 1, 2002, through June 30, 2003, this provision would allow FTB to identify eligible taxpayers with high-risk collection accounts and offer those taxpayers the opportunity to satisfy an unpaid tax liability by paying the tax in full and receiving a waiver of interest, penalties, and fees. For purposes of this provision, the following terms are defined:

- Eligible taxpayer – any taxpayer notified by FTB that their unpaid tax liabilities may be satisfied with the payment of an “eligible amount.”
- Eligible amount – an amount equal to the “unpaid tax liability” less interest, penalties, and fees. The amount must be paid in one or more installments, as determined by FTB, before the due date established by FTB, which would be no later than June 30, 2004.
- High-risk collection account – any “unpaid tax liability” where satisfaction is in the best interest of the state. These accounts include any unpaid tax liability where FTB determines:
 - efforts to collect the unpaid tax would be uneconomical, or
 - the unpaid tax liability would not be fully paid within a reasonable period of time.
- Unpaid tax liability – any final assessment under the Personal Income Tax Law including tax, penalties, interest, and fees that are owed by an individual and are unpaid as of October 1, 2002. Assessments resulting from a proposed assessment issued to a taxpayer for the failure to file a tax return are excluded.

In addition, this provision would clarify that:

- No refund or credit will be granted for any penalty or interest paid prior to October 1, 2002.
- The determinations made by FTB under this provision are final and conclusive.
- FTB will not be required to disclose standards used in making the determinations under this bill or the information used for determining those standards if it is determined that the disclosure will seriously impair assessment, collection, or enforcement of the income tax laws.
- FTB is not authorized under this provision to compromise any final tax liability, and the laws regarding administrative regulations and rulemaking are not applicable for purposes of implementing and administering this provision.
- A public record must be made of each high-risk collection account that receives a waiver of penalties, interest, or fees. The public record must include the taxpayer’s name, amount of fees, penalties, and interest waived, and a summary of the reason the waiver is in the best interest of the state.

This provision of the bill would be repealed as of December 31, 2004.

IMPLEMENTATION CONSIDERATION

Although this provision would significantly impact the department, as stated below under Fiscal Impact, implementation of this provision could be accomplished by the operative date of October 1, 2002.

PROGRAM BACKGROUND

FTB currently uses an automated billing/collection system to collect the majority of its delinquent accounts. Taxpayers with tax delinquencies receive one or more notices that range from notices of tax due, to notices that provide that continued failure to pay will result in additional collection actions, to notices of state tax liens. FTB's notices of state tax liens are routinely issued on PIT delinquencies when the amount is sufficient to warrant such action.

If after several years, FTB cannot locate assets belonging to the debtor and determines that the chances of collecting a delinquency would be remote, the account may be discharged from collection accountability pursuant to the Government Code. However, in the event an employer, a bank account, or any other readily accessible asset is identified, FTB uses its automated system to issue levies on those assets. In addition, if an overpayment of tax from another tax year is subject to refund, the overpayment is applied against the discharged delinquency before any remaining overpayment is refunded.

LEGISLATIVE HISTORY

AB 3230 (Hannigan; Stats. 1984, Ch. 1490) provided for an amnesty program for individual taxpayers relating to the nonpayment and underreporting of tax or the nonpayment of any previously assessed tax.

ABX 8 and AB 2635 (Martinez; 1997-98) both would have provided an income tax amnesty program. The revenue generated from the program would have been transferred to special funds to provide disaster loss assistance and provide relief from damages caused by uninsured motorists, respectively. Neither bill passed its first policy committee.

AB 1849 (Budget Committee, 2001-2002) contains a similar provision to pursue collection of high-risk accounts. This bill is on the Senate floor awaiting a third reading.

SB 1439 (Oller, 2001-2002) would create an amnesty program for certain taxpayers that have failed to file income tax returns. This bill is with the Assembly Appropriations Committee.

OTHER STATES' INFORMATION

According to information furnished by the Federation of Tax Administrators, many states have offered, or are currently offering, tax amnesty programs similar to SB 1439 as described above. Although some of the states offer tax amnesty to taxpayers that have unpaid liabilities in their current accounts receivables inventory as well as those taxpayers that have not filed returns, it is unclear whether the unpaid accounts were required to meet specific criteria to be eligible for amnesty.

FISCAL IMPACT

The costs to implement this provision have been estimated at \$3.3 million for 41 limited-term positions (32.5 PYs) effective for the period of September 1, 2002, through August 31, 2003. This bill would require the department to make programming changes to various systems and implement quality control procedures, train staff, develop and maintain a database, respond to inquiries from both eligible and non-eligible taxpayers, and manually process 500,000 accounts and the related correspondence.

ECONOMIC IMPACT

Revenue Estimate

This provision would increase state revenue by \$125 million during fiscal year 2002-03.

Revenue Discussion

The projected revenue increase is based on a universe of 500,000 high-risk accounts with an average unpaid tax of \$2,500 at a projected recovery rate of 10%, resulting in a \$125 million revenue gain. Due to the type of accounts involved in this proposal, it is expected that any of this accelerated revenue that may have been collected in subsequent years would be insignificant in amount. Therefore, no revenue offset is projected for subsequent years.

POLICY CONCERNS

This provision could be construed to be unfair since many taxpayers with unpaid tax liabilities would not be eligible for, or offered the relief of, this provision since the department may not consider these taxpayers to be high-risk. In addition, the enactment of this provision and SB 1439 could cause confusion for taxpayers since this provision would require FTB to notify taxpayers that are eligible for interest, penalty, and fee relief as opposed to SB 1439, which would require taxpayers to apply for tax amnesty.

This provision could improve compliance with state tax laws and accelerate the collection of accounts that are determined to be at high risk for collection.

5. CONFORM TO FEDERAL BAD DEBT DEDUCTION RULES FOR BANKS

PURPOSE OF THE PROVISION

It appears that the intent of this provision is to conform to federal law concerning bank bad debt deductions.

EFFECTIVE/OPERATIVE DATE

This bill is an urgency statute; thus, it would be effective immediately, and apply to taxable years beginning on or after January 1, 2002.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under **federal law**, for taxable years after 1986, bad debts are deducted in the year they become worthless unless the taxpayer is allowed to use the reserve for bad debt method under IRC Section 585. Under this method, the additions to the reserve that may be deducted cannot bring the reserve above the loans outstanding at year-end, multiplied by a six-year moving average percentage (the experience method). Under current federal law, the term “bank” includes a domestic building and loan association (a thrift institution)(IRC Section 581).

Banks (including a thrift institution) are the only taxpayers allowed to use that method and only if they are not “large banks” (including thrift institutions). A large bank (including a thrift institution) is one where the average of all its assets is greater than \$500 million during any taxable year beginning after December 31, 1986.

Under current **California law**, all banks, mutual savings banks, co-operative banks, building and loan associations, and other savings institutions are allowed to use the reserve for bad debt method regardless of the size of its assets. In addition, the experience method calculations under the California regulations are based on the greater of a three- or six-year moving average rather than the federal six-year moving average. California law also provides that an additional amount may be deducted if the taxpayer is able to establish that additions to the reserve under the normal California computation are insufficient to absorb anticipated losses. In no event may loss charged to reserve for any loan be greater than that charged or reported to regulatory agencies, or reported in financial statements (R&TC Section 24348).

Federal law provides a corporate AMT rate of 20%. Existing **state law** provides a corporate AMT rate of 6.65%. A taxpayer with substantial income can use preferential tax benefits, such as exclusions, deductions, and credits, to reduce their income tax liability. AMT was established to ensure that a taxpayer who can use preferential tax benefits does not completely escape taxation.

THIS PROVISION

This provision would conform to federal law (IRC Section 585) with respect to the bad debts. Thus, for taxable years beginning on or after January 1, 2002:

- Bad debts would be deducted in the year they become worthless unless the taxpayer is allowed to use the reserve for bad debt method under IRC Section 585.
- Banks (including a thrift institution) are the only taxpayers allowed to use that method and only if they are not “large banks (including thrift institutions).” A large bank (including a thrift institution) is one where the average of all its assets is greater than \$500 million during any taxable year beginning after December 31, 1986.
- This provision does not provide any carryback rules, any election options contained in federal 1986 or 1995 transitional rules under IRC Section 585 or IRC Section 593, or any changes to the net operating loss rules. Instead, it goes directly to the rules contained in IRC Section 585.
- However, for purposes of adjustment of income under Article 6 of Chapter 13, this provision would allow the bad debt reserves at the beginning of 2002 to be taken into account at an amount of 50% of the applicable excess reserve (as defined in IRC Section 585) at the end of the first tax year beginning on or after January 1, 2002. A financial institution not meeting the definition of a “large bank” would not have to recognize any excess to income.

Additionally, this provision eliminates the AMT tax preference item that was generated by the excess of the deduction allowed by the reserve method over the actual method.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

AB 428 (Budget Committee, 2001-2002) contains a similar provision conforming to federal bad debt deduction rules for banks and modifying related AMT items. The bill is on the Senate floor awaiting a third reading.

SB 1849 (Budget Committee, 2001-2002) contains a similar provision conforming to federal bad debt deduction rules for banks and modifying related AMT items. The bill is on the Assembly floor awaiting a third reading.

OTHER STATES' INFORMATION

Based on available information regarding other states, 15 states, including North Carolina and Texas, do not impose an income tax or franchise tax on banks, so the bad debt reserve is not part of the tax base and not an issue. There are 27 states, including Massachusetts, Michigan, and Illinois, that conform to federal treatment of bad debts and have not allowed large banks to use the reserve method of accounting for bad debts since 1986, and have not allowed large thrifts to use the reserve method of accounting for bad debts since 1995. Of the remaining seven states, four allow a reserve method of accounting more restrictive than the federal method. Three states, including Alabama, New York, and South Carolina (as well as California), allow a less restrictive reserve method of accounting for bad debts.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This provision would increase state revenue by \$285 million during fiscal year 2002-03, and by \$15 million during fiscal year 2003-04.

Revenue Discussion

Estimates above reflect revenue gains from taking into account 50% of the excess reserve balances when an entity changes to the specific charge-off method, a method based on writing off actual account balances rather than an estimate of total losses. Remaining reserve balances would not be subject to recapture.

Additional revenue effects would result in a repeal scenario due to the net difference in annual additions to reserves and specific charge-offs against income. The bad debt reserve method is generally considered more favorable to the taxpayer than the specific charge-off method. Assuming lender loan bases (the total amount of loans that may be subject to loss) continue to increase, this favorable relationship would continue. Therefore, we would expect additional revenue gains attributed to the difference in deductions. The revenue gains are expected to be very small relative to the impact of the recapture of bad debts.

6. SUSPEND THE VLF OFFSET-EFFECT ON STATE INCOME TAX REVENUE

PURPOSE OF THE PROVISION

It appears that the intent of this provision is to increase VLF fees.

EFFECTIVE/OPERATIVE DATE

This bill is an urgency statute; thus, it would be effective immediately, and, by its terms, operative for vehicle license fees with a final due date in the calendar year beginning on January 1, 2003.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

California law establishes, in lieu of any *ad valorem* tax upon vehicles, an annual license fee for any vehicle subject to registration in this state in the amount of 2% of the market value of the vehicle. The VLF law offsets this amount by 67.5% for fees due on or after July 1, 2001, and appropriates funds to reimburse local governments for revenue losses.

Current **federal and state laws** allow individuals an itemized deduction for taxes paid based on the value of property, including the annual license fee.

Current **federal and state laws** allow business to deduct their ordinary and necessary expenses. These costs can be deducted even though the benefit they generate may extend past the taxable year in which the cost was paid or incurred.

THIS PROVISION

This provision would suspend the scheduled offset amount of 67.5% and substitute an offset amount of 25%. Also, the proceeds would be appropriated to local governments. The effect of this is to raise the amount paid for the annual license fee.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not impact the department's programs and operations.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Additional state revenue generated by higher VLF fees would be offset by a decrease in state income tax revenue of \$85 million during fiscal year 2003-04.

Revenue Discussion

This revenue estimate reflects the revenue loss from increased itemized deductions and business expense deductions as a result of increasing the VLF. The revenue estimate was based on the department's Personal Income Tax model and projections made for the VLF tax increase.

LEGISLATIVE STAFF CONTACT

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